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DEPARTMENT FOR EB/IFD
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TAGS: EFIN EINV PGOV GM
SUBJECT: GERMANY DEBATES HEDGE FUND REFORM; BACKS
MULTILATERAL MONITORING

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¶1. SUMMARY. Hedge funds are politically contentious in Germany. The two major political parties in Chancellor Angela Merkel's "Grand Coalition" have staked out opposing positions on whether Germany should reform its hedge fund regulations. The three major German financial agencies -- the Bundesbank, the German Financial Services Supervisory Authority (BaFin), and the Ministry of Finance -- are advocating separate policy recommendations. This uncertain policy environment could have an impact on U.S. investors, who make up approximately 90 percent of Germany's hedge fund industry. German officials and bankers say the public feels uneasy about hedge fund strategies. Bundesbank economists and other German financial experts point to hedge fund risks that could undermine financial stability. END SUMMARY.

INTRODUCTION TO HEDGE FUNDS IN GERMANY

¶2. Hedge funds are defined in Germany as "funds with additional risk" that allow leverage, the use of derivatives, and short sales. Germany is a late-comer to the hedge fund market, having only created a legal basis for hedge funds in ¶2004. It is also unique among countries in that its financial regulatory agency (BaFin) monitors hedge funds. Single hedge funds cannot be publicly traded and may only be marketed through credit institutions and financial service providers authorized for investment and contract broking; they are not permitted to invest in real property and real property companies; and their investments in enterprises not part of an exchange or organized market are limited to 30 percent of the value of the fund.

¶3. Fund of Hedge Funds (FoHFs), which are defined as investment asset pools that invest at least 51 percent of their value in individual hedge funds, are additionally targeted by German regulations. Unlike single hedge funds, marketing of FoHFs is allowed, but FoHFs must provide investors with a detailed sales prospectus containing information on the features of the product as well as the following warning in bold print: "Warning by the Federal Minister of Finance: Investors in this investment fund must be prepared and able to sustain losses of the capital invested up to a total loss." Short sales, leverage, cascades, and borrowings are not permitted; a maximum of 20 percent of the value of a FoHF may be invested in a single target fund; FoHFs may not invest in more than two target funds of the same issuer or fund manager; and funds must have no more than 49 percent liquidity. There is also a lengthy application process for FoHFs that takes between 2-6 months to complete. In addition to requiring FoHFs to disclose

detailed, audited annual and semi-annual reports, BaFin holds the right to solicit any information regarding a FoHF's investments.

¶4. In June, the German Bundesbank and the European Central Bank issued warnings on the systemic risks that hedge funds pose for the international markets. There are approximately 8,600 hedge funds worldwide, worth more than USD 1.4 trillion. The hedge fund industry's lack of transparency and the high-stakes investment strategies that these hedge funds pursue are causing many German experts and politicians to express significant concern regarding the lack of international standards for regulating hedge funds. Former Chancellor Gerhard Schroeder proposed at the 2005 G-8 meeting in the UK a multilateral approach to monitoring hedge funds to reduce potential risks to financial stability -- a policy the Finance Ministry continues to pursue (REFTEL). Germany's Bankers' Association also acknowledges that hedge funds pose significant risks to the banking sector because it fears hedge funds would quickly liquidate debt holdings in times of market stress. Jochen Sanio, President of BaFin, believes that hedge funds are undoubtedly dangerous to the financial system, noting at a German conference recently that "the question is not if, but when the next hedge fund disaster will take place." As a result, the German Parliament and federal financial agencies are beginning to consider ways to mitigate the potential risks that hedge funds pose to the financial market.

MUCH POLITICAL ADO ABOUT HEDGE FUNDS

¶5. Hedge funds have struggled with an image problem in Germany since the 2005 election campaign. Vice-Chancellor

and former Social Democratic Party Chairman Franz Muentefering likened hedge funds in Germany, which are mainly managed by U.S. investors, to "locusts" that pillage German medium-sized firms by restructuring, closing certain operations, and re-selling them. Muentefering's hedge fund rhetoric captured popular interest in Germany, garnering up to 75 percent support in public opinion polls. Hedge funds remain news even after the election, as the general public continues to view hedge funds with suspicion and distrust.

¶6. Finance State Secretary Thomas Mirow and other officials believe hedge funds' negative image in Germany is due to the foreign ownership of most hedge funds and a lack of financial literacy among the general public. Embassy contacts in the finance industry note the German public feels a deep-seated, culturally ingrained distrust of the finance industry -- and this distrust is only reinforced by negative press and recent concern by industry experts about the risks of hedge funds. According to some experts, this cultural uneasiness about debt financing and financial leveraging will likely prevent Germany from embracing the hedge fund industry.

¶7. Not surprisingly, the finance industry is frustrated by recent called to curb the activity of hedge funds and increase federal regulations. Industry experts note that since enabling legislation in 2004, the growth of the USD 2 billion hedge fund industry in Germany has been disappointing. According to Bundesbank figures, only 20 domestic single hedge funds and 14 FoHFs have registered with the German authorities. Industry experts also claim that Germany's current, comparatively high level of hedge fund regulation is driving investors away from Germany and toward its major European competition (e.g. in Luxembourg, Switzerland, and the UK).

HEDGE FUND REGULATION AT A CROSSROADS

¶8. Quite divergent proposals on hedge funds are floating in the German government. German officials expect that the

future direction of hedge fund regulation in Germany will be determined by the ability of the political parties in power to overcome their conflicting positions on the issue. Currently, there is no indication that this is occurring: The Social Democratic Party (SPD) continues to fan the flames of the "locust" debate that Muentefering began during the 2005 election campaign and supports the retention of the current level of hedge fund regulation; the Christian Democratic Party (CDU/CSU), which shares majority power with the SPD in the "Grand Coalition", wishes to foster a Frankfurt-based hedge fund industry and wants to lighten the regulatory burden; and the Left Party, which is in the minority, wants to eliminate hedge funds entirely from Germany.

¶9. The three legislative initiatives before Parliament include:

OPTION 1 - BAN HEDGE FUNDS IN GERMANY: In late 2005, with an eye toward attracting voters skeptical about hedge funds, the Left Party introduced a proposal in the German Parliament to ban hedge funds. The Left Party argued that hedge funds have become too risky and are threatening Germany's financial stability. Just before the 2006 summer recess, the Parliament's finance committee passed its recommendation not to support the Left's proposal. German officials believe the likelihood of Germany banning hedge funds in the near future is very low.

OPTION 2 - INCREASE REGISTRATION REQUIREMENT: In an effort to increase the transparency of hedge fund activity, the Finance Ministry is currently considering increasing the number of funds falling under domestic regulation of single hedge funds. Currently, single hedge funds in Germany are required to register with BaFin once they invest in at least 5 percent of a company's value. The German government is now deliberating whether to lower this threshold to 3 percent. German officials believe the livelihood of Germany enacting this new rule is very high, as neither industry interest groups nor political parties have yet to voice opposition to the proposal.

OPTION 3 - DECREASE REGULATORY BURDEN: Even while supporting the new registration threshold rule, the Finance Ministry is also drafting a proposal to revise the current investment laws governing hedge fund regulation in order to reduce other regulatory measures and make them more "business-friendly".

The Finance Ministry avidly seeks to foster growth in Germany's own hedge fund industry in Frankfurt. Although the details of the proposal are not yet available, Finance Ministry officials are confident their proposal will pass the German Parliament by January 2007 with strong support from the financial industry.

¶10. INTERNATIONAL OR EUROPE-WIDE REGULATION: In May, the Bundesbank unveiled several proposals that called for greater international and/or Europe-wide regulation of hedge funds. Edgar Meister, a member of the Bundesbank's executive board, called for a "code of conduct" modeled on the scheme developed by IOSCO for oversight of credit rating agencies; he further proposed that hedge funds voluntarily submit to credit rating agency assessments. The German Bankers' Association, BaFin and the Finance Ministry support the Bundesbank's proposal. In general, while Germany's private sector and government are in favor of international or Europe-wide regulation of the hedge fund industry, they doubt any such plan could be realized in the near future. They claim that diverging interests at the EU level, as well as at the international level, will prevent moving soon toward a multilateral solution to hedge funds. German officials explain that, as one of the few countries to regulate hedge funds, Germany naturally seeks an international approach that would bind financial centers to the same rules for hedge funds.

REITs: CANARY IN THE COAL MINE?

¶11. Although the outcome of the hedge fund regulation debate remains unclear, Embassy contacts suggest that the outcome of a parallel debate already in Parliament on the legalization of REITs (Real Estate Investment Trusts) will be an important indicator for how the hedge fund debate will turn out. Like hedge funds, REITs have been labeled "locusts" by the Social Democrats and their legalization has emerged as a politically divisive issue. Financial industry groups are interested in REITs, as Germany's real estate market is valued at an estimated USD 9.5 trillion. The Finance Ministry's Mirow believes the REITs draft law proposal could be the bellwether for revealing the political parties' true positions on legislation for promoting Germany's financial industry (SEPTEL).
TIMKEN JR